22.07 Intercompany Transactions

The process of consolidation results in the presentation of a single set of F/S, which treats the Acquirer and Acquiree as a single entity. Since an entity cannot engage in business transactions with itself, adjustments will have to be made on the consolidating worksheet in order to eliminate the effects of **intercompany transactions.** There are four types of such transactions that commonly appear on the CPA exam:

- **Dividends paid** from the Acquiree to the Acquirer.
- **Sales of inventory** from one of the companies to the other.
- Sales of **property, plant, and equipment** from one to the other.
- Purchases by one of the **bonds** issued by the other.

In principle, an eliminating entry has a simple objective: to remove any evidence from the consolidated F/S that the event occurred. If a transaction produced a receivable and payable, the elimination would involve debiting the payable and crediting the receivable. If a transaction produced a revenue and expense account, the elimination would involve debiting the revenue and crediting the expense.

There are, however, special complications associated with each of the 4 transactions cited above, since their effects often involve income on one side of the transaction but not on the other. These can be exceptionally complicated when the income is being reported by the acquiree in cases where the acquirer owns less than 100% of the acquiree. For the CPA exam, though, questions about intercompany transactions have consistently directed the candidate to ignore the noncontrolling interest (minority interest). As a result, there is no need to make distinctions between **upstream** (acquiree-to-acquirer) and **downstream** (acquirer-to-acquiree) transactions.

Dividends paid by the acquiree to the acquirer must be completely eliminated in a consolidation, since an entity cannot pay dividends to itself. The manner in which the elimination entry is made depends on the accounts presented in the exam problem. Actually, there is no effect on the balance sheet to remove, since the equity accounts of the acquiree and the investment of the acquirer are eliminated in the combining of equity. The only exception is if a dividend has been declared but not yet paid, in which case an elimination of the receivable and payable may be needed:

Dividends payable	100	
Dividends receivable		100

When there is a noncontrolling interest, dividends payable to the noncontrolling shareholders are not eliminated, since they are actual amounts owed to outside creditors. Additionally, since they represent the portion of the acquiree not owned by the acquirer, they won't be included in the combined equity of the consolidated entity anyway.

On rare exams, a consolidating worksheet will include the statement of retained earnings and I/S. When this has occurred, the acquirer has always used the cost method to account for the investment, reporting dividend income from the acquiree.

The eliminating entry is as follows:

Dividend income (I/S)	100	
Dividends paid (R/E)		100

When only a balance sheet is presented, this entry isn't needed, since both accounts are closed to retained earnings at year-end.

Dividends paid by the acquirer are not eliminated (except in the rare cases that the acquiree owns some stock in the acquirer, in which case that part is eliminated). As a result, once an acquisition has taken place, the consolidated statement of retained earnings will only report dividends paid by the acquirer. This is consistent with the fact that the equity accounts of the acquiree are eliminated in a consolidation.

Intercompany sales of inventory are the most common intercompany transactions. They have as many as three effects on the F/S that may need to be eliminated:

- Sale vs. Purchase
- Receivable vs. Payable
- Profit in Ending Inventory

Let's assume that P Company has an item in inventory that was purchased from an outside suppler for $4, and that it is sold to S Company late in the year for $5. It remains in the ending inventory of the subsidiary at year-end, and the invoice has not yet been paid to the parent.

The elimination of the intercompany sale-purchase is as follows:

Sales	5	
Cost of sales		5

Remember that purchases are included in the computation of cost of sales, explaining the credit side of the entry. Keep in mind the above entry need not be made in an exam problem asking only for balance sheet effects, since both of the above accounts are closed into retained earnings at year-end.

The elimination of the intercompany receivable-payable is as follows:

Accounts payable	5	
Accounts receivable		5

The elimination of the intercompany profit ending inventory ($5 – $4 = $1) is as follows:

Cost of sales	1	
Inventory		1

Remember that ending inventory is included in the computation of cost of sales, explaining the debit side of the entry. If the problem only requires preparation of a balance sheet, the debit is made to retained earnings instead of cost of sales.

Of course, in most cases, the intercompany buyer will have paid for some or all of the goods purchased during the year, so the intercompany receivable-payable entry will be less than the intercompany sale-purchase entry. Also, some or all of the purchased goods will have been resold to outsiders before year-end, so the profit to be eliminated will not be the profit on all sales, only that on the purchased items still remaining at year-end.

When one of the companies in a consolidated group **sells a depreciable or amortizable asset to the other**, two eliminations will probably be needed:

1. Elimination of the gain on sale.
2. Elimination on the additional depreciation or amortization resulting from the markup of the asset.

Let's say P has equipment with a $50 cost and $20 accumulated depreciation on 1/1/X1, and sells it to S for $45. On the date of sale, the asset has an estimated remaining life of 3 years. In order to see the effects of the sale, look at the following comparison:

Account	Acquirer P	Acquiree S	Change
Equipment	50	45	(5)
Accumulated depreciation	(20)	(0)	20
Book value	30	45	15
20X1 depreciation	10	15	5

To eliminate the changes that resulted from the sale itself, the following entry is made:

Gain on sale of equipment	15	
Equipment	5	
Accumulated depreciation		20

Notice that this entry returns the equipment to its $50 cost and $20 accumulated depreciation. If only a balance sheet is presented in the problem, the gain is debited to retained earnings instead.

Although not theoretically preferred, the following entry will correct the book value, and is permissible as an alternative:

Gain on sale of equipment	15	
Equipment		15

After reducing the book value of the asset from $45 to $30, the depreciation over the subsequent year must be reduced in preparing financial statements for the year ended 12/31/X1:

Accumulated depreciation	5	
Depreciation expense		5

This reduces the depreciation from $15 to $10 for the year. In a balance sheet problem, the credit to depreciation expense is made to retained earnings instead.

Finally, **bonds issued** by one of the companies may be purchased by the other, and there are as many as three eliminations that may be needed:

- Investment in bonds vs. bonds payable
- Interest revenue vs. interest expense
- Accrued interest receivable vs. accrued interest payable

Let's assume that the acquiree issued an 8% bond at its $1,000 face value several years ago, and that the acquirer purchased the bond on the open market for $900 plus accrued interest on 12/31/X1. Also assume the bond pays interest annually on January 1.

To eliminate the bond itself, the following entry is made:

Bond payable	1,000	
Investment in bond		900
Gain on retirement		100

Notice that the purchase of the bond of one company by the other is treated as an early retirement, as it would have been had a single entity bought its own bond on the open market.

Since annual interest of $1,000 × 8% = $80 is due tomorrow, the acquirer must have paid $80 accrued interest on the purchase date, and this must be eliminated as well:

Accrued interest payable	80	
Accrued interest receivable		80

Since the bond was purchased at the end of the year, no intercompany interest income has resulted, so there is no elimination. Had the bonds been held throughout the year, not merely acquired at year-end, interest revenue and interest expense would have been eliminated, though the different carrying values of the bond would have created complications that the exam has avoided testing.

Intercompany Transactions – Summary

- **Intercompany PP&E**
  - Seller of PP&E:

Cash or A/R	100	
Accumulated Depreciation	60	
PP&E		120
Gain		40

  - Purchaser of PP&E:

PP&E	100	
Cash or A/P		100

  - To Fix on Worksheet at year end:

Gain	40	
PP&E	20	
Accumulated Depreciation		60

  - To fix over depreciation (40/10 = $4):

Accumulated Depreciation	4	
Depreciation Expense		4

- **Intercompany Bonds**
  - Issuer of bonds at face/par value

Cash	1,000	
B/P		1,000

- My subsidiary purchases the bonds from the outside investor for $980 (1,000 – 20 discount = 980 CV):

Investment	1,000	
Cash		980
Discount		20

- To eliminate on the worksheet at year end:

Bonds payable	1,000	
Investment in Bonds		980
Gain on retirement		20

- **Intercompany inventory sales**
  - Seller of Inventory:

Cash	100	
Sales Revenue		100
COGS	80	
Inventory		80
(note that intercompany profit is $20 or 20% of 100)		

- Purchaser of Inventory:

Inventory	100	
Cash		100

- Assume the purchaser sells 90% of the inventory purchased for $200:

Cash	200	
Sales Revenue		200
COGS	90	
Inventory		90

- To eliminate on the worksheet at year end:

Sales Revenue	100	
Inventory (20% profit in ending)		2
COGS		98

If given a Worksheet, eliminate the following Entries (Panic approach):

- Investment account = always zero at the end
- Eliminate 100% of acquiree's – C/S, APIC, R/E
- Set up noncontrolling interest (adjust for % of income and dividends)
- Dividend income if cost method or investment income if equity method
- Dividends paid by Acquiree
- Intercompany transactions (sales, COGS, unrealized inventory profits)
- Intercompany gains/losses on sale of PP&E
- Intercompany receivables/payables
- Bond investments
- Set up excess FMV of PP&E over BV
- Record goodwill
- Record depreciation on excess FMV of PP&E
- Record Impairments of goodwill

Some problems on the CPA exam involve the use of a **three-part worksheet**, consisting of an I/S section, a section for the statement of retained earnings, and a balance sheet section. When provided a three-part worksheet, the best approach is to:

1. Post all of the adjusting journal entries to the worksheet.
2. Complete the I/S section by:
   - Calculating the net balance for each I/S line item.
   - Total each column for the I/S section. The net amount in the final column will be net income.
3. Complete the statement of retained earnings section by:
   - Copying the totals from the I/S section on the net income line of the statement of retained earnings section.
   - Calculating the net balance for each line item in the section.
   - Total each column for the section. The net amount in the final column will be ending retained earnings.
4. Complete the balance sheet section by:
   - Copying the totals from the statement of retained earnings section on the retained earnings line of the balance sheet section.
   - Calculating the net balance for each line item in the section.
   - Total each column for the section.

The following **additional disclosures** are also required:

- The portion of consolidated net income and comprehensive income attributable to both the acquirer and the noncontrolling interest.
- The amounts attributable to the noncontrolling interest for each of the following:
  - income from continuing operations;
  - Discontinued operations; and

  - Components of other comprehensive income.
- A reconciliation of the annual change in reported amounts of noncontrolling interest, including separate disclosure of the following:
  - Consolidated net income attributable to noncontrolling interest;
  - Investments by and distributions to noncontrolling interest; and
  - Each component of comprehensive income.
- A footnote schedule showing the effects of transactions with the noncontrolling interest on the equity attributable to the noncontrolling interest.

Combined Financial Statements

Combining the financial positions and results of operations of related entities may be useful to financial statement users even though the requirements for the preparation of consolidated F/S have not been met. Although consolidated F/S may not be prepared when one entity does not have a controlling financial interest in another, it may be appropriate to prepare **combined F/S**. Combined F/S are often prepared, for example, for two or more entities that have common ownership, such as the unconsolidated subsidiaries of a parent. Combined F/S may also be prepared for two or more entities under common management.

Combined F/S are very similar to consolidated F/S in that the effects of interentity transactions are eliminated. They are different, however, in that:

- Amounts are not adjusted to fair values.
- The equity accounts are combined rather than being eliminated.

Variable Interest Entities (VIE)

Under ASC 810, a reporting entity is required to include another entity in its consolidated F/S when the reporting entity has a controlling financial interest in it. An entity can have a controlling financial interest in another entity without owning any equity in the other entity, in which case the controlled entity is referred to as a **variable interest entity (VIE)**. The reporting entity with a controlling financial interest is referred to as the **primary beneficiary** and is required to prepare consolidated F/S that include the VIE.

A VIE relationship often occurs as a result of one of two common circumstances:

- An entity forms a separate entity for the purpose of holding certain assets or incurring liabilities. This may be done to keep items off of the balance sheet, referred to as *"off balance sheet financing."* It also may be done for legitimate business reasons, such as setting up a separate entity to acquire assets to be leased to the reporting entity while passing tax benefits to the owners.
- An entity enters a relationship with another that occupies so many of the other entity's resources and becomes the focus of its operations, making the other entity essentially a division of the reporting entity.

The reporting entity will evaluate significant relationships with other entities to determine if it is the primary beneficiary of a VIE. The evaluation consists of 4 steps:

1. The natures of the entities and their relationship are evaluated to determine if there is a potential for a VIE, considering certain *exempt relationships* identified in ASC 810 (eg, a for-profit entity will generally not consolidate with a not-for-profit entity).

- If the other entity qualifies as a business, it is not subject to the VIE rules. This exemption does not apply, however, when the business, by its design, operates primarily for the benefit of the reporting entity.

2. The potential VIE is evaluated to determine if it is self-sufficient or if there are indications that it is dependent on some form of additional subordinated financial support. Does the other entity have *one or more characteristics of a VIE*?
   - There may not be sufficient equity to sustain normal operations.
   - The equity holders may not have the normal characteristics of equity holders.
3. The reporting entity determines if it has a *variable interest in the potential VIE*, meaning that it will be affected if the value of the other entity's assets increase or decrease.
4. The reporting entity determines if it is the *primary beneficiary*, which is an entity with a variable interest in the potential VIE that both:
   - Has the *power* and authority to *direct* the *operations* and activities of the potential VIE that are most significant to its economic performance.
   - Participates in the VIE's *profits and losses* to an extent that is potentially *significant* to the VIE.

When a reporting entity determines it is the primary beneficiary of a VIE, it is required to prepare consolidated F/S, treating the VIE as a subsidiary.

- If the entities are **not related**, the creation of the relationship will be treated as comparable to an acquisition and the same principles for recognizing the combination and for preparing consolidated F/S will be followed.
  - Assets and liabilities of the VIE are reported at their **fair values**.
  - The VIE's equity accounts are eliminated.
  - The noncontrolling interest may represent 100% of the equity of the VIE.
- If the entities are **related**, the combination and subsequent consolidated F/S will be prepared using **book values**.

Alternative VIE Accounting Approach for Nonpublic Entities

The Private Company Council (PCC) has established an alternative accounting approach for nonpublic entities. A private reporting entity does not need to evaluate a legal entity under the VIE GAAP guidance if *all* of the following conditions apply:

- The reporting and legal entities are under common control.
- Neither of the entities are under the common control of a public company.
- The legal entity is not a public company.
- The reporting entity does not have a controlling financial interest in the legal entity.

If the alternative accounting approach is elected, it must me be applied to all legal entities that fit the criteria above.

A reporting entity that elects this approach should disclose the following:

- The nature and risks of being involved with the legal entity.
- How involvement with the legal entity affects the reporting entity's financial position.
- Carrying amounts and classification of assets/liabilities on the balance sheet resulting from such involvement.

- The maximum exposure to loss resulting from such involvement, or if it can't be quantified, a disclosure that says so.

  If the exposure to loss exceeds the carrying amounts of assets/liabilities, information that explains the excess exposure, such as terms of arrangements that may require the reporting entity to provide financial support.